

EMBARGOED UNTIL 2:30 P.M. EST

Text as Prepared for Delivery

March 24, 1998

TREASURY DEPUTY SECRETARY LAWRENCE H. SUMMERS  
SENATE COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION

Mr Chairman, thank you for giving me this opportunity to discuss economic and financial aspects of tobacco legislation proposals presently before Congress. As you know, President Clinton strongly supports the efforts of yourselves and others in Congress to forge comprehensive legislation, consistent with the principles he outlined last fall, to protect America's children from the deadly threat of smoking.

At Treasury and throughout the Administration we have been and will remain one hundred percent committed to working with this Committee and others in Congress to address an issue of such enormous consequence for the health of the American people and our economy.

I would like to focus my remarks today on the proposals in the President's budget and their implications for public health, something that will depend critically on the increase in cigarette prices. I will also address the concern that comprehensive tobacco legislation in line with the President's core principles would impose unmanageable adjustment costs on tobacco suppliers and the tobacco industry as a whole.

First, however, let me say a few words about the background for this discussion: the enormous burden that smoking imposes on our nation and our economy; the need to cut teen smoking to start reducing that burden; and the President's call for comprehensive legislation to achieve that goal.

**I. Combating Smoking: the Need for a Comprehensive Approach**

*1. The Human and Economic Costs of Smoking*

Smoking is by far the largest preventable cause of premature death in the U.S. As Dr. David Satcher noted in his testimony last week, over 400,000 Americans die each year of tobacco-related diseases. This toll exceeds the deaths from AIDS, homicide, suicide, alcohol use, illegal drug use, fires and auto accidents combined. Recent estimates suggest that on present patterns of tobacco-use, an estimated 25 million of today's Americans will die prematurely from a smoking-related disease.

Behind these heavy human costs of smoking lie equally heavy economic costs for our nation:

- we spend about \$60 billion each year treating smoking related illnesses. On its own, smoking during pregnancy -- which results in 2500 fetal deaths and doubles the odds of being born with low birth weight and potentially suffering problems later in life as a result -- costs the country some \$3-4 billion every year;
- fires caused by smokers cost another \$500 million -- and 2000 lives -- per year;
- smokers with group life insurance push up the premiums of the non-smokers in their insurance pool by about \$4 billion dollars per year;

We must also consider the enormous cost to our economy from all the premature retirements and premature deaths of productive workers that are caused by smoking -- amounting to \$60 billion or more in lost wages.

## *2. The Importance of Reducing Teen Smoking*

There is a strong consensus on the need to reduce smoking in this country and the heavy costs that smoking brings with it. And there is an equally strong consensus on the most effective way to achieve that goal. It is to stop smoking when it starts -- in adolescence. Nine out of ten smokers start when they are in their teens. And the record shows that once they start smoking, they are unlikely to stop.

Each day, 3000 young people become regular smokers. Fully one third of them will have their lives cut short by it, because it causes an addiction that is very hard to shake later on. Nearly half of teen daily smokers think they will not be smoking five years later. Yet only one fifth actually manage to quit. One half of teen smokers try to quit and fail; and by age 18, two-thirds have already regretted starting. The regret is understandable: nearly half of adult smokers try to quit every year, but only about 2.5 percent succeed.

## *3. The Need For a Comprehensive Approach*

The Administration's efforts are guided by another lesson of experience: that preventing youth smoking demands a comprehensive attack on the problem, an approach that makes tobacco companies part of the solution. The fact is that the piecemeal approaches of past years have not worked. Youth smoking has continued to grow through the 1990s and shows no sign of declining.

What is required is a coordinated, comprehensive approach based around the five core components that the President outlined last fall:

- a combination of annual payments and penalties designed to achieve targeted reductions in teen smoking by raising the price of a pack of cigarettes by up to \$1.50.

- full authority for the Food and Drug Administration to regulate tobacco products;.
- real changes in the way the tobacco industry does business, including an end to marketing and promotion to children.
- progress toward other public health goals, including biomedical and cancer research, a reduction of second-hand smoke, promotion of smoking cessation programs, and other urgent priorities
- protection for tobacco farmers and their communities

We believe that all five of these components are critical to a solution and are mutually reinforcing: the effectiveness of any one is substantially increased by the presence of the others. For example, studies in Massachusetts and California suggest that while increasing the price of cigarettes is one of the most cost-effective short-term strategies for reducing tobacco consumption, the ability to sustain that reduction is significantly increased when the price increase comes with a comprehensive anti-smoking campaign along the lines outlined above. And the more we are able to coordinate our efforts across state and county lines, the more effective such an approach will be.

## **II. The Economic Implications of a Comprehensive Approach**

It is in the nature of this comprehensive approach to combat youth smoking that it will involve many parts of our government working together. Thus, several of the components I have described will properly be matters for other departments to address. In my remarks I shall focus mainly on two interrelated aspects of the Administration's approach that are of particular relevance to Treasury: the implications for the pricing of cigarettes and the prevalence of youth smoking. I also will say a few words about the implications for tobacco farmers and manufacturers.

### **1. The Implications for Cigarette Prices and Youth Smoking**

#### *Implications for Prices*

A large body of evidence suggests that the most effective way to reduce smoking by young people is to raise the price of cigarettes. Thus, to measure the impact of any tobacco legislation on youth smoking we need to measure the impact on the price of cigarettes to consumers.

The President's budget calls for assessments which would result in cigarette price increases. As Table 1 shows, the budget plan's impact on prices would rise from 62 cents in 1999 to \$1.10 in 2003 in constant dollars. Let me be clear: this figure represents the increases that would be directly attributable to the passage of comprehensive legislation. It does not represent the anticipated increase in the base price of cigarettes during a period in which a number of relevant features of the surrounding environment will be changing. For example, there is the

increase in federal excise taxes scheduled to take place over the next five years.

As Table 1 further indicates, we anticipate that without any legislation the baseline price will rise from \$1.94 today to \$2.09 in 2003 in real terms. Combining this rise in the baseline price with the \$1.10 increase resulting from the President's budget, the total price of a pack of cigarettes in 2003, in constant dollars, is projected to be \$3.19.

Mr. Chairman, although such price levels are common in many other countries, they are higher than those we have experienced in the United States. We have been and will continue to be mindful of the many uncertainties about how an increase of this kind will ultimately translate into retail prices. Because our primary goal in this endeavor is to advance public health through the reduction of teen smoking, we have been conservative in many of our calculations in order not to risk falling short of our goals.

Specifically:

- we have assumed that wholesalers and retailers will not add their existing mark-ups to the settlement costs passed on by manufacturers. In fact, virtually all of the relevant empirical evidence<sup>1</sup> suggests that there will be very little "pyramiding" of this kind. That is why the FTC, in their analysis of the original Attorneys General settlement, assume in their baseline that there would not be this kind of mark-up of the payments made by manufacturers in the prices paid by consumers.
- we assume the major increase in pricing nationwide would come as a consequence of federal action in the context of comprehensive legislation, and not as a result of significant tax increases on the part of the states.
- finally, we have not included in our forecasts the additional impact of state sales taxes on the final price of cigarettes, on the grounds that these are not part of the posted price of cigarettes at the point of sale.

It may be that, as several commentators have suggested, these assumptions -- along with our assumptions on other matters such as black and gray market activity, which I will discuss

---

<sup>1</sup>For example, Barnett, Keeler, and Hu's 1995 study estimated a pass-through rate from federal taxes to retail prices of about 102 percent over the 1955 to 1990 period. Sumner's 1981 study over state tax increases the 1954-1978 period found a pass-through rate of 103 to 107 percent, and Merriman's 1994 study estimated a rate of 106 percent.

<sup>2</sup>For example, Martin Feldman of Salomon, Smith, Barney has estimated that the President's budget will result in a total price per pack which is 34 cents beyond our estimate of \$3.19. However, 30 cents of this extra rise can be explained by his assumption that wholesalers and retailers will add to their existing price mark-ups -- an assumption which runs against virtually all relevant empirical evidence. Another prominent industry analyst, Gary Black of Sanford

below -- are too conservative.<sup>2</sup> I might also note, in this context, that we have assumed that the vast majority of the legislation's cost will be passed on to United States consumers of domestic cigarettes rather than to the shareholders in tobacco companies or consumers of other goods produced by these companies. Clearly the uncertainties involved leave room for reasonable people to disagree.

If our estimates turn out to have understated the eventual impact on prices -- which we do not expect -- the health benefits envisioned in the President's budget would be achieved that much more quickly. Our estimates show that for every 10 cents added to the price of cigarettes, approximately 700,000 fewer teenagers will begin smoking -- and more than 200,000 premature deaths will be avoided.

### *Overall Implications for Youth Smoking*

As I noted earlier, the impact of any given price increase on youth smoking will be significantly increased by other elements of the comprehensive approach the President has called for -- notably, a crackdown on youth marketing and advertising by tobacco companies and more effective enforcement of legal restrictions on tobacco sales to young people.

Studies have found a 69 percent decline in daily use by seventh and eighth graders in Woodridge, Illinois following legislation and enforcement of restrictions on cigarette sales to minors, and a 44 percent decline in junior high school students' smoking in Leominster, Massachusetts as a result of strictly enforced sales restrictions. For our own estimates, we used a conservative assumption that experts have recommended -- that comprehensive sales and marketing restrictions will reduce youth smoking by about 15%.

The combination of the price increase anticipated above and the tighter restrictions on youth access and marketing leads to dramatic reductions in youth smoking. Table 2 presents these results, showing that the price increase reduces teenage smoking by 29%. Youth access and market restrictions reduce teenage smoking by an additional 11%. Furthermore, we estimate that our plan will:

- reduce the number of youths smoking each year by as many as 1.9 million by 2003;
- reduce the cumulative number of youths who smoke between now and 2003 by 3 million;
- and avoid roughly 1 million premature deaths as a result.

These estimates suggest the value of such a comprehensive approach to combating teen smoking. But we cannot and will not let our success in this effort depend on the accuracy of today's best estimates. The many uncertainties involved in making these predictions only underline

---

Bernstein, in his analysis of the June 20 settlement, projects these mark-ups will actually fall.

the importance of incorporating in any legislation the Administration's concrete targets for reducing youth smoking. These aim to cut youth smoking by 30% after 5 years, 50% after 7 years, and 60% after 10 years. And in the strong youth lookback penalties that the President has proposed we have additional insurance that these targets will be met.

We have had fruitful discussions with the staffs of a number of members of both the House and Senate about the appropriate structure of youth lookback penalties, and we recognize that there are several different ways of providing the necessary insurance. But we believe that any lookback penalty structure should not be tax deductible and should meet two principles:

- it must be levied on both the industry as a whole and on individual companies specifically. These two types of penalty structures serve two different purposes. The industry penalties, which are likely be passed on to price, provide "price insurance", relying on the best tool we have (cigarette prices) to lower youth smoking if we miss our targets. The company specific penalties, on the other hand, provide "non-price insurance," holding specific companies accountable for their actions in selling tobacco products to youth and thereby providing a profit incentive to take other actions to reduce youth use of their products.
- the penalties must be sizeable in those cases where the industry or specific firms miss their targets by a substantial margin. This could be accomplished, for example, by having penalties that increase with the distance the company is from its target.

Let me add that as part of our economic analysis we have also considered issues relating to possible black and gray market activity following legislation. As Figure 1 shows, even in the context of legislation that produced a price increase significantly higher than that presently being considered, cigarette prices in the United States would still be significantly lower than has proved workable in other countries.

The fact that the price increase is primarily to be achieved through direct payments by the tobacco companies should significantly ease the task of enforcement relative to other cases in which the increase is achieved through higher excise taxes at the retail level. But as you know, we have been working with your staff and others on a proposed system of licensing and registration to control the diversion of tobacco and prevent any smuggling that may occur.

## **2. The Implications For the Tobacco Industry**

Questions have arisen about the impact of legislation on tobacco manufacturers and their suppliers. We are confident that the changes in pricing and behavior that we are seeking can be achieved without putting producers' livelihoods or the health of the broader economy at risk.

*Tobacco farmers*

There are more than 124,000 American farmers engaged in the production of tobacco in this country. Largely concentrated in certain, heavily tobacco-dependent regions, they and their families have already been forced to undergo difficult adjustments as the overall demand for tobacco in this country has declined. We cannot and will not leave these highly vulnerable families and communities behind in crafting a comprehensive approach to reducing smoking much faster in the years to come.

That is why one of the President's principles is protection for tobacco farmers and their communities. And it is why we have supported, in this context, the efforts of the many Senators and House members who have been working to provide for this protection. One method of protecting these farmers is continuing production control programs, such as that included in the LEAF Act supported by Senators Ford, Hollings, and Frist. The Administration agrees that controls on production can be one element of a system that meets the President's five principles, and we look forward to being able to support the product of your work in this area.

As we go forward the President is committed to working with Congress to find the best way both to protect the health of our children and to protect the economic well-being of our farmers. So, too are the coalition for public health and tobacco farming organizations that last week endorsed a set of principles with which both groups could agree. These organizations include the Burley Tobacco Growers Cooperative, the Flue-Cured Tobacco Stabilization Corporation, the American Heart Association, the American Cancer Society, and the Campaign for Tobacco Free Kids. And let me add: we are determined that one important use of the funds raised by higher prices on cigarettes will be the provision of funds to protect the economic well-being of tobacco farmers and their communities.

#### *Tobacco manufacturers*

The best evidence suggests that comprehensive legislation consistent with the President's five principles would come at some detriment to the profitability of American tobacco companies. However, it is important to bear in mind that a central feature of both the settlement and all of the legislation that has been proposed to date is an expectation -- indeed, an express desire -- that companies will pass the costs on to the price of tobacco products.

To the extent that the costs are indeed passed on to prices, the impact on the profitability of these companies will be less than many have perhaps imagined and certainly insufficient to create major disturbance to the economy. The FTC analysis of the June 20 Attorneys General settlement suggested that the total impact of the settlement would lead to, at most, a 15 percent reduction in tobacco industry profits. Applying similar methodologies to the President's budget proposals -- and bearing in mind, once again, the very large uncertainties that exist -- suggests a reduction in operating profits of around 23 percent.

There is also the separate question of how the market would value any given stream of profits in the event that comprehensive legislation reduced some portion of the substantial legal uncertainties these companies presently face. It has been widely acknowledged by Wall Street

analysts that the resolution of some of the uncertainties facing this industry will increase the market valuation of the future income streams of tobacco firms. This effect would tend to offset the reduction that I noted in the level of these future income streams.

### **III. Concluding Remarks**

Members of the Committee, as the President has said: "we stand on the verge of one of the greatest public health achievements in history -- an historic triumph in our fight to protect America's children from the deadly threat of tobacco." The opportunity is there for the taking: in the comprehensive, five-part approach that the President has called for and so many in Congress are striving to achieve.

The stakes are high. Every day that we do not take action means that another 3,000 young people will become regular smokers. Just in the time that I have been speaking to you, 20 children have started smoking, and 7 of them will die prematurely as a result. We cannot afford to delay one child longer. If we pass comprehensive legislation that meets the targets laid out in our budget, in five years' time around 40 percent fewer American children will be smokers; in 10 years time, the number will have been halved. I look forward to working closely with you, Mr Chairman, with the members of this committee and with others in Congress as we work to take this historic step forward for the future of our nation and the future of our economy. I would now welcome any questions.